

Financials

ProspEx Resources Ltd.

Annual Report 2005



ProspEx Resources Ltd. is a junior oil and gas company focused on exploration in Western Canada and headquartered in Calgary. Formed through a Plan of Arrangement with Esprit Exploration Ltd. in October 2004, our objective is to be a top quartile junior exploration company, by deploying our technical expertise to generate per share growth in production and reserves while applying cost discipline to maximize netbacks.

The Annual General Meeting of ProspEx's shareholders will be held on Monday, May 15, 2006, at 10:00 a.m. in the Lecture Theatre of the Metropolitan Centre, 333 - 4th Avenue S.W., Calgary, Alberta. All shareholders are welcome to attend. Those unable to do so are invited to complete, sign and return a Form of Proxy

Certain information regarding ProspEx Resources Ltd. ("ProspEx" or the "Company") including management's assessment of future plans and operations, constitutes forward-looking information or statements under applicable securities law and necessarily involves assumptions regarding factors and risks that could cause actual results to vary materially, including, without limitation, assumptions and risks associated with oil and gas exploration, development, exploitation, production, marketing and transportation, loss of markets, volatility of commodity prices, currency fluctuations, imprecision of reserve estimates, environmental risks, competition, incorrect assessment of the value of acquisitions, failure to realize the anticipated benefits of acquisitions and ability to access sufficient capital from internal and external sources.

The reader is cautioned that these factors and risks are difficult to predict and that the assumptions used in the preparation of such information, although considered reasonably accurate by ProspEx at the time of preparation, may prove to be incorrect. Accordingly, readers are cautioned that the actual results achieved will vary from the information provided herein and the variations may be material. Readers are also cautioned that the foregoing list of factors is not exhaustive. Additional information on these and other factors that could affect ProspEx's operations or financial results are included in ProspEx's reports on file with Canadian securities regulatory authorities. In particular see ProspEx's Management Discussion and Analysis and the Risk Factors and Industry Conditions sections of ProspEx's Annual Information Form. ProspEx's reports may be accessed through the SEDAR website (www.sedar.com), at ProspEx's website (www.psx.ca) or by contacting the Company directly. Consequently, there is no representation by ProspEx that actual results achieved will be the same in whole or in part as those set out in the forward-looking information.

Furthermore, the forward-looking statements contained in this annual report are made as of the date of this annual report, and ProspEx does not undertake any obligation to update publicly or to revise any of the included forward-looking statements, whether as a result of new information, future events or otherwise. The forward-looking statements contained herein are expressly qualified by this cautionary statement.

BOE's may be misleading, particularly if used in isolation. A boe conversion ratio of six thousand cubic feet to one barrel is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead.

Financial and Operating Highlights

	For the year ended Dec. 31, 2005	For the three months ended Dec. 31, 2004
Financial (\$000s, except per share amounts)		
Oil and gas revenue	\$ 35,472	\$ 7,302
Net earnings	\$ 12,831	\$ 1,105
Per Share – basic	0.27	0.03
– diluted	0.26	0.02
Cash flow	\$ 23,351	\$ 4,338
Per Share – basic	0.49	0.10
– diluted	0.47	0.10
Total assets	\$ 120,970	\$ 77,368
Total long-term liabilities	\$ 6,815	\$ 3,584
Production Volumes		
Natural gas (mcf/d)	11,087	11,740
Natural gas liquids (bbls/d)	72	37
Crude oil (bbls/d)	24	4
Total (boe/d) (6:1)	1,944	1,998
Average Sales Prices		
Natural gas (\$/mcf)	\$ 8.29	\$ 6.60
Natural gas liquids (\$/bbl)	51.37	46.42
Crude oil (\$/bbl)	68.27	49.74
Total (\$/boe)	50.00	39.73
Average Netbacks (\$/boe)		
Price	50.00	39.73
Financial instrument	(0.07)	-
Royalties	(7.93)	(7.49)
Operating costs	(5.78)	(5.82)
General and administrative costs	(2.54)	(2.70)
Total	\$ 33.68	\$ 23.72
Capital (\$000s)		
Drilling and completions	\$ 39,622	\$ 6,536
Facilities	9,990	2,836
Land and lease	6,289	160
Seismic	1,760	1,014
Capitalized general and administrative expenses	1,402	495
Office and computer assets	94	356
Total	\$ 59,157	\$ 11,397

Management Discussion & Analysis

Management's Discussion & Analysis ("MD&A") is management's assessment of the historical financial and operating results of ProspEx Resources Ltd. ("ProspEx" or the "Company") as well as a prospective view of the Company's activities. The MD&A was prepared as at March 13, 2006 and should be read in conjunction with the audited consolidated financial statements for the year ended December 31, 2005 and the three months ended December 31, 2004. The consolidated financial statements have been prepared in accordance with generally accepted accounting principles ("GAAP") in Canada. Readers are referred to the advisories detailing "Disclosure Controls and Policies", "Non-GAAP Measures" and "Forward-Looking Statements" contained in the back of this MD&A. Additional information relating to ProspEx, including our Annual Information Form, can be found at www.sedar.com.

ProspEx commenced operations on October 1, 2004 when certain assets of Esprit Exploration Ltd. ("Esprit") were transferred to ProspEx upon the completion of a Plan of Arrangement (the "Plan of Arrangement"). As a result, comparative information is only for the three months ended December 31, 2004. For additional information regarding the Plan of Arrangement see note 2 to the consolidated financial statements.

Vision, Core Business And Strategy

ProspEx is a junior oil and gas exploration company based in Calgary, Alberta whose business activities are focused in the Western Canadian Sedimentary Basin. Our strategy is to create value primarily through the generation and drilling of exploration prospects as well as through the exploitation and development of our existing properties.

Key Performance Drivers

ProspEx's goal is to add value by discovering and developing oil and gas reserves "through the drill-bit". Efforts to achieve this are largely focused on managing risk and controlling costs. Key performance drivers such as reserve replacement, recycle ratios, finding and development costs, operating and general and administration costs are monitored.

In addition, ProspEx strives to ensure it receives competitive prices for commodities sold. Sales prices and overall netbacks are considered in achieving ProspEx's goal of adding overall shareholder value.

Finally, financial performance measures including net income and cash flow on a per common share basis are used to assess overall performance.

Highlights of 2005

ProspEx successfully executed a \$59.2 million capital program resulting in finding and development costs (including future development capital) of \$17.06 per boe on a proved plus probable basis, a reserve replacement ratio of 613% and an increase in the reserve life index from 5.7 years at the end of 2004 to 10.4 years at the end of 2005. Total proved plus probable reserves increased 87% during the year to 7.8 million boe. A large portion of these reserve adds were realized in the last quarter of 2005 and therefore are not yet on production.

Oil and gas revenue of \$35.5 million or \$50.00 per boe was realized in 2005.

Cash flow of \$23.4 million or \$0.47 per diluted share was enhanced by the maintenance of a low cost structure, with royalties averaging only 16% of revenue and operating costs of \$5.78 per boe. ProspEx's 2005 operating netback before G&A was \$36.29, resulting in a proved plus probable recycle ratio of 2.1.

Fourth Quarter 2005 Results

The final quarter of 2005 was highlighted by a successful winter drilling program which was accelerated into the early part of the winter drilling season. During the quarter, \$26 million was spent on exploration and development resulting in 22 gross (12.9 net) wells drilled. ProspEx exited 2005 with production of approximately 2,300 boe per day, and expects first quarter 2006 production to average 2,500 to 2,600 boe per day. Annual average production for 2006 is forecast to be 3,100 to 3,300 boe per day.

Fourth quarter revenue and net earnings are up from the third quarter of 2005 primarily due to strengthening commodity prices and production growth. The average price realized by ProspEx rose 31% from the previous quarter to \$65.89 per boe. Production for the fourth quarter of 2,062 boe per day is up 5% from the third quarter of 2005 as a result of new production brought on at the end of the third quarter in West Central Alberta as well as decreased down times at Salter during the quarter.

Results Of Operations

Revenue

(\$000s)	For the year ended Dec. 31, 2005	For the three months ended Dec. 31, 2004
Natural gas	\$ 33,531	\$ 7,125
NGLs	1,346	157
Oil	595	20
Total operating revenue	35,472	7,302
Unrealized financial instrument loss	(51)	-
Total petroleum and natural gas sales	\$ 35,421	\$ 7,302

Revenue from natural gas, oil and natural gas liquids ("NGLs") for 2005 totaled \$35.5 million compared to \$7.3 million for the three months ended December 31, 2004. Throughout 2005 revenue grew quarter over quarter due to steady production growth and strengthening commodity prices.

Production

Starting from our October 1, 2004 production level of 1,473 boe per day, 2005 production averaged 1,944 boe per day comprised of 11.1 million cubic feet ("mmcf") per day of natural gas and 96 barrels ("bbls") per day of oil and NGLs. Production decreased slightly from 2004 exit production levels early in 2005 as natural declines were not fully offset by the tie-in of new wells as warm winter weather and a wet spring delayed the execution of the 2005 capital program. Production grew quarter over quarter in 2005 as Deep Basin and West Central Alberta drilling successes were tied-in. ProspEx exited 2005 with production of approximately 2,300 boe per day and anticipates production for the first quarter of 2006 to be 2,500 to 2,600 boe per day.

ProspEx's overall production mix for 2005 was 95% dry gas, with 74% of production coming from the Medallion property.

Average Selling Price

	For the year ended Dec. 31, 2005	For the period Oct. 1, 2004 to Dec. 31, 2004
Natural gas (\$/mcf)	\$ 8.29	\$ 6.60
Oil and NGLs (\$/bbl)	55.40	46.88
Average realized price (\$/boe)	50.00	39.73
Unrealized financial instrument loss (\$/boe)	(0.07)	—
Total average price (\$/boe)	\$ 49.93	\$ 39.73

ProspEx realized an average gas price of \$8.29 per thousand cubic feet ("mcf") for the year, up 26% from \$6.60 per mcf realized in the last quarter of 2004, consistent with the increase in AECO postings over the periods. ProspEx currently markets 30% of its gas at the AECO monthly index while the remaining 70% is marketed at the AECO daily index.

Financial Instruments

On occasion ProspEx will enter into physical and financial fixed price contracts. ProspEx is authorized by the Board of Directors to hedge up to 50% of its production at any given time; however, it is ProspEx's policy not to enter into any physical or financial fixed price contracts with a term more than 18 months and any collar arrangements that go beyond two years.

At December 31, 2005, ProspEx had a costless collar for 2,500 gigajoules ("GJ") per day of production with a floor price of \$7.00 per GJ and a ceiling of \$11.66 per GJ at AECO. This collar will expire on March 31, 2006. On July 1, 2005, the Company elected not to continue to designate this financial instrument as a hedge and has accounted for it using the fair value method. As the fair value of the instrument at July 1, 2005 was \$nil, the entire \$50,800 change in the fair value of the instrument after that date is recorded on the balance sheet with an associated unrealized loss in the statement of earnings.

Subsequent to year end, ProspEx entered into a collar for 6,000 GJ per day from April 1, 2006 to October 31, 2006, with a floor price of \$6.75 per GJ and a ceiling of \$9.00 per GJ at AECO; purchased an AECO call option for 6,000 GJ per day from April 1, 2006 to October 31, 2006 at \$10.00 per GJ; and entered into a NYMEX to AECO basis contract for 2,637 GJ per day from April 1, 2006 to June 30, 2006 at NYMEX less US\$1.18 per GJ.

Royalty Expense

Royalties totaled \$5.6 million or 16% of oil and gas revenue in 2005 compared to \$1.4 million or 19% of revenue for the last quarter of 2004. Royalties as a percentage of revenue decreased in 2005 due to an increase in revenue from deeper wells with royalty holidays and higher capital cost allowance and custom processing deductions. ProspEx's royalty rate remains slightly lower than industry average, as a significant portion of current production is subject to lower freehold and gross override rates.

For 2006, the royalty rate is expected to be approximately 20% of revenues.

Operating Costs

Operating costs for the year were \$4.1 million or \$5.78 per boe. During the final quarter of 2004 the Company incurred operating costs of \$1.1 million or \$5.82 per boe. This modest decrease in operating cost per boe reflects the Company's focus on controlling costs despite a higher cost environment.

2006 operating costs per boe are expected to increase to \$6.50 per boe due to an increase in the proportion of the Company's production from higher cost areas in West Central Alberta and the Deep Basin, where the Company pays fees to utilize third party facilities.

General and Administrative Expenses

Total general and administration costs ("G&A") for the period were \$3.2 million. ProspEx follows the full-cost method of accounting for its petroleum and natural gas operations and as such, approximately 50% of exploration and development related G&A costs were capitalized leaving \$1.8 million expensed or \$2.54 per boe. Net G&A costs during the quarter ended December 31, 2004 were \$0.5 million or \$2.70 per boe. G&A costs were down in 2005 on a per boe basis due to the one time costs associated with the start-up of ProspEx incurred in 2004.

G&A costs are expected to decrease on a unit basis to \$2.25 per boe for 2006 as a result of an anticipated increase in overall production levels.

Interest and Bank Charges

Interest and bank charges in 2005 resulted in income of \$0.1 million, compared to a minimal expense in the fourth quarter of 2004. Current year interest income was the result of the remaining funds received from ProspEx's equity issuance on December 3, 2004. Funds were drawn from the line of credit late in the year to fund the fourth quarter capital program.

Depletion, Depreciation and Accretion

Depletion and depreciation expense for 2005 was \$9.8 million or \$13.87 per boe compared to \$1.6 million or \$8.65 per boe in 2004. The depletion rate on a per barrel basis rose as the current cost environment is higher than the historical costs. It is anticipated that the depletion rate will continue to increase marginally as the capital program is executed.

Accretion expense was \$0.3 million or \$0.40 per boe for 2005 compared to \$42,781 in the final quarter of 2004. Accretion expense is expected to continue to rise in conjunction with increased exploration and development activity.

Stock-based Compensation

Stock-based compensation is accounted for using the fair-value method. Under the fair-value method of accounting, this compensation expense is recorded in the earnings statement over the vesting period and 50% of the cost is capitalized. Stock-based compensation costs for 2005 were \$1.9 million and for the final quarter of 2004 were \$0.8 million.

Income Taxes

ProspEx did not pay any income taxes in 2005, with the exception of large corporations tax. The Company's future income taxes for the period resulted in a recovery of \$1.0 million for the year. During the year, an additional \$5.1 million was recorded as a future income tax asset and a corresponding increase in income as greater certainty on the utilization of remaining income tax pools was obtained, due to positive drilling results and a higher commodity price forecast.

ProspEx has approximately \$116.0 million of income tax pools at December 31, 2005 and does not anticipate being cash taxable in 2006. ProspEx has committed to incur \$6.1 million in qualifying expenditures related to the flow-through share financing by December 31, 2006.

Net Income and Cash Flow

As a result of strong commodity prices and ongoing cost control efforts, cash flow reached \$23.4 million or \$0.47 per diluted share in 2005 and net earnings totaled \$12.8 million or \$0.26 per diluted share. Net earnings were also increased by the recognition of an additional future tax asset of \$5.1 million. During the quarter ended December 31, 2004 cash flow was \$4.3 million or \$0.10 per diluted share and net earnings were \$1.1 million or \$0.02 per diluted share.

With continued production growth and cost control, the Company expects the trend of positive net income and cash flow for 2006 to continue.

Capital Expenditures

Total capital expenditures were \$59.2 million in 2005 compared to \$11.4 million during the last quarter of 2004. Details of these expenditures are as follows:

(\$000s)	Q1 2005	Q2 2005	Q3 2005	Q4 2005	Year ended Dec. 31, 2005	Three months ended Dec. 31, 2004
Drilling and completions	7,036	3,468	8,614	20,504	39,622	6,536
Facilities	3,148	2,229	636	3,977	9,990	2,836
Land and lease	1,344	3,776	223	946	6,289	160
Seismic	5	213	1,303	239	1,760	1,014
Capitalized G&A	424	301	341	336	1,402	495
Other capital assets	68	10	10	6	94	356
Total Capital Expenditures	12,025	9,997	11,127	26,008	59,157	11,397

During the year the Company incurred \$39.6 million in drilling and completion expenditures to drill 59 (37.2 net) wells. Of the \$6.3 million in land expenditures, \$4.2 million was spent in the Deep Basin and \$1.4 million in West Central Alberta. In addition, the Company incurred \$10.0 million in facilities, primarily on tie-in costs.

Of the \$59.2 million in capital expenditures, \$20.5 million was spent in the fourth quarter to drill 22 wells (12.9 net). ProspEx accelerated the winter drilling program into the fourth quarter of 2005 to reduce the Company's exposure to the busy winter market for drilling services.

The Board of Directors has approved a 2006 capital budget of \$60.0 million, of which \$9.0 million was accelerated into the fourth quarter of 2005, leaving \$51.0 million to be spent in 2006.

The 2005 capital program resulted in total proved plus probable reserve additions of 4.3 million boe resulting in finding and development costs of \$13.58, or \$17.06 after incorporating the change in future development costs.

Liquidity & Capital Resources

At December 31, 2005, ProspEx had the following resources available to fund its capital expenditure program.

Working capital deficiency	(16,967)
Long-term debt	(1,053)
Bank facilities available	40,000
Total capital resources	\$ 21,980

ProspEx expects that it will be able to fund its \$51 million 2006 capital program from cash flow at current strip prices and the capital resources listed in the table above.

Bank Debt

At December 31, 2005 the Company had a total credit facility of \$40.0 million. The facility is available by way of Canadian and US dollar prime rate based loans, LIBOR advances, bankers' acceptances and letters of credit. The credit facility is fully revolving until June 30, 2006 and may be extended at the mutual agreement of ProspEx and its lender for an additional year. If the credit facility is not extended, a balloon payment is required on July 1, 2007. This facility is secured by a \$200 million demand debenture and a first floating charge on all petroleum and natural gas assets of ProspEx.

Share Capital

The Company completed a private placement of approximately 6.4 million common shares and 3.2 million warrants on October 1, 2004 for proceeds of approximately \$9.0 million. These funds were used to reduce ProspEx's initial debt of approximately \$10.7 million.

On December 3, 2004 ProspEx completed a private placement of 6.9 million common shares for gross proceeds of \$20.0 million. These funds were used to fund the 2005 capital program.

On December 21, 2005 ProspEx issued 1.4 million common shares on a flow-through basis at a price of \$4.35 per share for total gross proceeds of \$6.1 million. ProspEx has committed to incur \$6.1 million in qualifying expenditures related to the flow-through share financing by December 31, 2006. Proceeds of the share offering will be used to fund the 2006 capital program.

As at December 31, 2005 ProspEx had 48,932,193 common shares, 3,031,642 warrants, 872,000 special performance units and 2,313,508 options issued and outstanding.

As at March 13, 2006 ProspEx had 48,942,043 common shares, 3,012,792 warrants, 872,000 special performance units and 2,980,008 options issued and outstanding.

Contractual Obligations

The Company has committed to certain payments over the next five years as follows:

(\$000s)	2006	2007	2008	2009	Thereafter
Long-term debt	\$ -	\$ 1,053	\$ -	\$ -	\$ -
Building Lease	350	353	353	29	-
Software licenses	108	-	-	-	-
Other	6	6	4	-	-
Total	\$ 464	\$ 1,412	\$ 357	\$ 29	\$ -

ProspEx has also committed to incur \$6.1 million in qualifying expenditures related to the flow-through share arrangement by December 31, 2006.

Summary of Quarterly Results

The following table summarizes the quarterly operating statistics of the Company. For the periods prior to October 1, 2004 the operating statistics are that of the assets transferred upon completion of the Plan of Arrangement:

	2005				2004			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Financial (\$'000s except per share amounts)								
Oil and gas revenue	6,426	7,447	9,103	12,496	–	–	–	7,302
Net earnings	827	1,829	6,325	3,850	–	–	–	1,105
Per share – basic	0.02	0.04	0.13	0.08	–	–	–	0.03
– diluted	0.02	0.03	0.13	0.08	–	–	–	0.02
Average Daily Production								
Oil (bbls/d)	14	21	32	28	21	14	13	4
NGLs (bbls/d)	47	52	96	91	54	45	43	37
Natural Gas (mcf/d)	10,712	10,963	11,013	11,651	7,573	7,665	8,502	11,740
Total (boe/d)	1,846	1,901	1,963	2,062	1,337	1,337	1,473	1,998
Operating Netback (\$/boe)								
Price ⁽¹⁾	38.68	43.05	50.40	65.89	36.26	37.62	38.02	39.73
Royalties	(6.41)	(6.24)	(8.59)	(10.15)	(7.45)	(7.06)	(5.99)	(7.49)
Operating	(5.73)	(5.42)	(5.14)	(6.77)	(4.74)	(5.35)	(6.38)	(5.82)
Operating Netback	26.54	31.39	36.67	48.97	24.07	25.21	25.65	26.42

Note: Quarterly results for Q1 – Q3 of 2004 are historical results of the assets transferred upon completion of the Plan of Arrangement.

⁽¹⁾ Price does not include unrealized financial instrument loss.

Related Party Transactions

In conjunction with the Plan of Arrangement, ProspEx and Esprit entered into an administrative and technical service agreement pursuant to which Esprit provided certain administrative and technical services to ProspEx. This agreement expired March 31, 2005. However, the information technology support portion of the agreement was extended until March 31, 2006. Total charges for the agreement in 2005 were \$123,524 (2004- \$94,074).

ProspEx also entered into a marketing arrangement with Esprit, under which ProspEx sold its production to Esprit for market prices less a marketing charge of \$0.02 per GJ until June 30, 2005. Total charges for the marketing agreement for 2005 were \$41,009 (2004 - \$22,012).

Also pursuant to the plan of arrangement ProspEx entered into an agreement to sublease office space from Esprit. During the year ProspEx received an incentive of \$0.4 million plus disbursement costs to surrender the initial sublease and enter into a new agreement to sublease office space until January 31, 2009 at a different location. The incentive is being drawn down over the term of the lease.

Off-balance Sheet Arrangements

The Company has not entered into any off-Balance Sheet transactions.

Operational And Other Business Risks

Need to Replace and Grow Reserves

The future oil and natural gas production of ProspEx, and therefore future cash flows, are highly dependent upon ongoing success in exploring on the Company's current and future undeveloped land base, exploiting the current producing properties and acquiring or discovering additional reserves. Without reserve additions through exploration, acquisition or development activities, reserves and production will decline over time as reserves are depleted.

The business of discovering, developing, or acquiring reserves is capital intensive. To the extent cash flows from operations are insufficient and external sources of capital become limited or unavailable, the ability of ProspEx to make the necessary capital investments to maintain and expand its oil and natural gas reserves may be impaired.

There can be no assurance that ProspEx will be able to find and develop or acquire additional reserves to replace and grow production at acceptable costs.

Exploration, Development and Production Risks

Oil and natural gas exploration involves a high degree of risk, which even a combination of experience, knowledge and careful evaluation may not be able to overcome. There is no assurance that expenditures made on future exploration by ProspEx will result in new discoveries of oil and natural gas in commercial quantities. It is difficult to project the costs of implementing an exploratory drilling program due to the inherent uncertainties of drilling in unknown formations, the costs associated with encountering various drilling conditions such as over pressured zones, tools lost in the hole and changes in drilling plans and locations as a result of prior exploratory wells or additional seismic data and interpretations thereof.

The long-term commercial success of ProspEx depends on its ability to find, acquire, develop and commercially produce oil and natural gas reserves. No assurance can be given that ProspEx will be able to continue to locate satisfactory properties for acquisition or participation. Moreover, if such acquisitions or participations are identified, ProspEx may determine that current markets, terms of acquisition and participation or pricing conditions make such acquisitions or participations uneconomic.

Future oil and gas exploration may involve unprofitable efforts, not only from dry wells, but from wells that are productive but do not produce sufficient net revenues to return a profit after drilling, operating and other costs. Completion of a well does not assure a profit on the investment or recovery of drilling, completion and operating costs. In addition, drilling hazards or environmental damage could greatly increase the cost of operations, and various field operations conditions may adversely affect the production from successful wells. These conditions include delays in obtaining governmental approvals or consents, shut-ins of connected wells resulting from extreme weather conditions, insufficient storage, processing or transportation capacity or other geological and mechanical conditions. While diligent well supervision and effective maintenance operations can contribute to maximizing production rates over time, production delays and declines from normal field operating conditions cannot be eliminated and can be expected to adversely affect revenue and cash flow levels to varying degrees.

In addition, oil and gas operations are subject to the risks of exploration, development and production of oil and natural gas properties, including encountering unexpected formations or pressures, premature declines of reservoirs, blow-outs, sour gas releases, fires and spills. Losses resulting from the occurrence of any of these risks could have a materially adverse effect on future results of operations, liquidity and financial condition.

Reserve Estimates

The production forecast and recoverable estimates contained in the ProspEx Engineering Report are only estimates and the actual production and ultimate recoverable reserves from the properties may be greater or less than the independent estimates of GLJ.

There are numerous uncertainties inherent in estimating quantities of reserves and cash flows to be derived there from, including many factors that are beyond the control of ProspEx. The reserve and cash flow information set forth herein represent estimates only. The reserves and estimated future net cash flow from the assets of ProspEx have been independently evaluated effective December 31, 2005 by GLJ. These evaluations include a number of assumptions relating to factors such as initial production rates, production decline rates, ultimate recovery of reserves, timing and amount of capital expenditures,

marketability of production, future prices of oil and natural gas, operating costs and royalties and other government levies that may be imposed over the producing life of the reserves. These assumptions were based on price forecasts in use at the date the relevant evaluations were prepared and many of these assumptions are subject to change and are beyond the control of ProspEx. Actual production and cash flows derived therefrom will vary from these evaluations, and such variations could be material. The foregoing evaluations are based in part on the assumed success of exploitation activities intended to be undertaken in future years. The reserves and estimated cash flows to be derived therefrom contained in such evaluations will be reduced to the extent that such exploitation activities do not achieve the level of success assumed in the evaluations.

Volatility of Oil and Natural Gas Prices

The operational results and financial condition of ProspEx will be dependent on the prices received for oil and natural gas production. Oil and natural gas prices have fluctuated widely during recent years and are determined by supply and demand factors, including weather and general economic conditions as well as conditions in other oil and natural gas regions. Any decline in oil and natural gas prices could have an adverse effect on the operations, proved reserves and financial conditions of ProspEx and could result in a reduction of the net production revenue of ProspEx causing a reduction in its oil and gas acquisition and development activities. In addition, bank borrowings which might be made available to ProspEx are typically determined in part by the borrowing base of the reserves of ProspEx. A sustained material decline in prices from historical average prices could reduce the borrowing base of ProspEx, therefore reducing the bank credit available to ProspEx and could require that a portion of such bank debt be repaid.

ProspEx uses the full cost method of accounting for oil and natural gas properties. Under this accounting method, capitalized costs are reviewed on a quarterly basis for impairment to ensure that the carrying amount of these costs is recoverable based on expected future cash flows. To the extent that such capitalized costs (net of accumulated depreciation and depletion) less future taxes exceed the present value of estimated future net cash flows from the proved oil and natural gas reserves of ProspEx, those excess costs would be required to be charged to operations.

Operational Hazards and Other Uncertainties

Oil and natural gas exploration operations are subject to all the risks and hazards typically associated with such operations, including hazards such as fire, explosion, blowouts, and oil spills, each of which could result in substantial damage to oil and natural gas wells, production facilities, other property and the environment or in personal injury. In accordance with industry practice, ProspEx is not fully insured against all of these risks, nor are all such risks insurable. Although ProspEx will maintain liability insurance, where available, in an amount which it considers adequate and consistent with industry practice, the nature of these risks is such that liabilities could exceed policy limits, in which event ProspEx could incur significant costs that could have a material adverse effect upon its financial condition. Business interruption insurance may also be purchased for selected facilities, to the extent that such insurance is available. Oil and natural gas production operations are also subject to all the risks typically associated with such operations, including premature decline of reservoirs and the invasion of water into producing formations.

Oil and natural gas exploration and development activities are dependant on the availability of drilling and related equipment in the particular areas where such activities will be conducted. Demand for such equipment or access restrictions may affect the availability and/or cost of such equipment to ProspEx and may delay exploration and development activities. To the extent ProspEx is not the operator of its oil and gas properties, ProspEx will be dependent on other operators for timing of activities related to non-operated properties and will be largely unable to direct or control the activities of the operators.

Although property title reviews will be done according to industry standards prior to the purchase of most oil and natural gas producing properties or the commencement of drilling wells, such reviews do not guarantee or certify that an unforeseen defect in the chain of title will not arise to defeat the claim of ProspEx which could result in a reduction of the revenue received by ProspEx.

Competition

There is strong competition relating to all aspects of the oil and natural gas industry. ProspEx will actively compete for capital, skilled personnel, undeveloped land, reserve acquisitions, access to drilling rigs, service rigs and other equipment, access to processing facilities and pipeline and refining capacity, and in all other aspects of its operations with a substantial number of other organizations, many of which may have greater technical and financial resources than does ProspEx.

Key Personnel

The success of ProspEx will depend in large measure on certain key personnel. The loss of the services of such key personnel could have a material adverse affect on ProspEx. ProspEx does not have key person insurance in effect for management. The contributions of these individuals to the immediate operations of ProspEx are likely to be of central importance. In addition, the competition for qualified personnel in the oil and natural gas industry is intense and there can be no assurance that ProspEx will be able to continue to attract and retain all personnel necessary for the development and operation of its business.

Environmental Risks

The oil and natural gas industry is subject to environmental regulation pursuant to a variety of international conventions and Canadian federal, provincial and municipal laws, regulations, and guidelines. A breach of such regulations may result in the imposition of fines or issuances of clean-up orders in respect of ProspEx or its assets. Such regulation may be changed to impose higher standards and potentially more costly obligations on ProspEx. There can be no assurance that future environmental costs will not have a material adverse effect on ProspEx.

Critical Accounting Estimates

ProspEx's significant accounting policies are contained in Note 1 to the consolidated financial statements. Certain of these policies are recognized as critical because in applying these policies management is required to make judgments, assumptions and estimates that have a significant impact on the financial results of ProspEx. The estimates used in applying these critical accounting policies have been discussed with the Audit Committee and are outlined below.

Oil and Gas Reserves

100% of the Company's proved plus probable oil and gas reserves were evaluated and reported on by an independent qualified reserves evaluator. However, the process of estimating oil and gas reserves is complex and is subject to uncertainties and interpretations. Estimating reserves requires significant judgments based on available geological and reservoir data, past production and operating performance and forecasted economic and operating conditions. These estimates may change substantially as additional data from ongoing development, testing and production becomes available, and due to unforeseen changes in economic conditions which impact oil and gas prices and costs. The Company's reserves and revisions to those reserves have a significant impact on net earnings as they are a key component in calculating depletion of oil and gas assets and oil and gas asset impairments. Net revisions to reserves during the current period were not significant.

Asset Impairment

ProspEx follows the Canadian Institute of Chartered Accountants ("CICA") Accounting Guideline 16 for full cost oil and gas accounting. In accordance with full cost accounting, a ceiling test is performed on a quarterly basis to test for impairment. An impairment loss may be recorded if the sum of the undiscounted cash flows expected from the production of the proved reserves and the lower of cost and market of unproved properties does not exceed the carrying values of the oil and gas assets. An impairment loss is recognized to the extent that the carrying value exceeds the sum of the discounted cash flows expected from the production of proved and probable reserves and the lower of cost and market of unproved properties.

The cash flows used in testing for impairment are based on a number of estimates, the two most significant being future prices and reserves. The uncertainty in reserves is discussed above. We estimate our future prices based on the forward market, adjusted for basis, quality and transportation at the end of the period for the first 10 years, after which the estimate of price is determined by our independent reserve evaluator. Although these price estimates are independent of the Company, they are still subject to significant volatility. Operating costs are estimated using current operating costs per barrel plus an inflation factor.

Certain costs related to unproven properties are excluded from costs subject to depletion until proven reserves have been determined or their value is impaired. These properties are reviewed quarterly and any impairment is transferred to the costs being depleted.

Asset Retirement Obligation

The Company records a liability for the legal obligation associated with the retirement of long-lived assets and a corresponding increase in the related asset in accordance with the method outlined by the CICA. The future liability is comprised of estimates of future costs to abandon and restore a well site and natural gas processing plants. The estimation of these costs are based on engineering estimates using current costs and technology and in accordance with current legislation and industry practice. These estimates are reviewed annually and could impact net earnings through an adjustment to the depletion, depreciation & amortization rate used by the Company.

Income Taxes

ProspEx follows the liability method of accounting for income taxes. At the end of each reporting period, the Company estimates its' tax pool balances and quantifies differences between the tax pools and the accounting balances. The Company has an excess of tax pools over its accounting balances. As a result, it has recorded a tax asset on that portion of excess tax pools where there is a high degree of certainty the tax pools will be utilized in the future. The determination of the amount of the tax asset is a matter of judgment. With the complexity of income tax laws and the use of estimations in determining the utilization of income tax pools, the income tax asset or liability may differ from that recorded.

ProspEx's income and other tax liabilities require interpretation of complex laws and regulations. All tax filings are subject to audit and potential reassessment after the lapse of time. Accordingly, the actual income tax asset or liability may differ from that recorded.

New Accounting Pronouncements

During the quarter ending March 31, 2006 ProspEx will adopt Section 3831 "Non-Monetary Transactions" as issued by the CICA. This section sets new standards for the measurement and disclosure of non-monetary transactions. It requires non-monetary transactions to be measured at the more reliably measurable of the fair value of the asset given up and the fair value of the asset received. The Company does not expect application of this new standard to have a material impact on its consolidated financial statements.

Disclosure Controls and Policies

Disclosure controls and procedures have been designed to ensure that information required to be disclosed by the Company is accumulated and communicated to the Company's management as appropriate to allow timely decisions regarding required disclosure. The Company's Chief Executive Officer and Chief Financial Officer have concluded, based on their evaluation as of the end of the period covered by the annual filings, that the Company's disclosure controls and procedures as of the end of such period are effective to provide reasonable assurance that material information related to the Company, including its consolidated subsidiary, is made known to them by others within those entities. It should be noted that while the Company's Chief Executive Officer and Chief Financial Officer believe that the Company's disclosure controls and procedures provide a reasonable level of assurance that they are effective, they do not expect that the disclosure controls and procedures will prevent all errors and fraud. A control system, no matter how well conceived or operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met.

Advisories

Non - GAAP Measures

Within the MD&A references are made to terms commonly used in the oil and gas industry. The following terms are not defined by GAAP in Canada and are referred to as non-GAAP measures.

1. Cash flow is defined as cash flow from operations before the change in non-cash working capital. The MD&A contains the term "cash flow" which should not be considered an alternative to, or more meaningful than "cash flow from operations" as determined in accordance with GAAP. The Company considers cash flow to be a key measure as it demonstrates the Company's ability to generate the cash necessary to fund capital projects and to repay debt. Cash flow presented does not have any standardized meaning prescribed by Canadian GAAP and therefore it may not be comparable with the calculation of similar measures for other entities. Cash flow per share is calculated using the same weighted average number of common shares for the period as used in calculating the net earnings per share calculation.
2. Barrel of oil equivalent ("boe") amounts have been calculated using a conversion rate of six thousand cubic feet ("mcf") of gas to one barrel of oil. Boe may be misleading if used in isolation. A boe conversion ratio of one barrel of oil to six mcf of gas is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the well head.
3. Netbacks equal total revenue less royalties, operating costs and general and administrative costs on a boe basis. Total boes are calculated by multiplying the daily production by the number of days in the period.

Forward-looking statements

Certain information regarding ProspEx Resources Ltd. including management's assessment of future plans and operations, constitutes forward-looking information or statements under applicable securities law and necessarily involve assumptions regarding factors and risks that could cause actual results to vary materially, including, without limitation, assumptions and risks associated with oil and gas exploration, development, exploitation, production, marketing and transportation, loss of markets, volatility of commodity prices, currency fluctuations, imprecision of reserve estimates, environmental risks, competition, incorrect assessment of the value of acquisitions, failure to realize the anticipated benefits of acquisitions and ability to access sufficient capital from internal and external sources.

The reader is cautioned that these factors and risks are difficult to predict and that the assumptions used in the preparation of such information, although considered reasonably accurate by ProspEx at the time of preparation, may prove to be incorrect. Accordingly, readers are cautioned that the actual results achieved will vary from the information provided herein and the variations may be material. Readers are also cautioned that the foregoing list of factors is not exhaustive. Additional information on these and other factors that could affect ProspEx's operations or financial results are included in ProspEx's reports on file with Canadian securities regulatory authorities. In particular see ProspEx's MD&A and the Risk Factors and Industry Conditions sections of ProspEx's Annual Information Form. ProspEx's reports may be accessed through the SEDAR website (www.sedar.com), at ProspEx's website (www.psx.ca) or by contacting the Company directly. Consequently, there is no representation by ProspEx that actual results achieved will be the same in whole or in part as those set out in the forward-looking information.

Furthermore, the forward-looking statements contained in this MD&A are made as of the date of this MD&A, and ProspEx does not undertake any obligation to update publicly or to revise any of the included forward-looking statements, whether as a result of new information, future events or otherwise. The forward-looking statements contained herein are expressly qualified by this cautionary statement.

BOE's may be misleading, particularly if used in isolation. A boe conversion ratio of six thousand cubic feet to one barrel is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead.

Management's Report

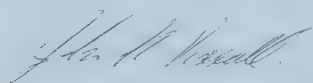
Management has prepared the consolidated financial statements in accordance with accounting principles generally accepted in Canada. If alternative accounting methods exist, management has chosen those methods it deems most appropriate in the circumstances. Financial statements are not precise as they include certain amounts based on estimates and judgments. Management believes such estimates have been based on careful judgements and have been properly reflected in the accompanying consolidated financial statements. Management has also prepared the financial information presented elsewhere in the annual report and ensured that it is consistent with information in the consolidated financial statements.

ProspEx Resources Ltd. maintains internal accounting and administrative controls designed to provide reasonable assurance that the financial information is relevant, reliable and accurate and that assets are appropriately accounted for and adequately safeguarded.

The Board of Directors is responsible for reviewing and approving the consolidated financial statements and Management's Discussion and Analysis and, primarily through its Audit Committee, ensures that management fulfills its responsibilities for financial reporting.

The Audit Committee is appointed by the Board and is composed of Directors who are not employees of the Company. The Audit Committee meets periodically with management and with the external auditors to satisfy themselves that management responsibilities are being properly discharged, to review the consolidated financial statements and to recommend approval of the consolidated financial statements to the Board. The Audit Committee also considers, for review by the Board and approval by the shareholders, the engagement or reappointment of external auditors.

KPMG LLP, the external auditors, have audited the consolidated financial statements in accordance with the auditing standards generally accepted in Canada on behalf of the shareholders. KPMG LLP has full and free access to the Audit Committee.



John W. Rossall
President & Chief Executive Officer



George D.K. Yee
Vice President, Finance & Chief Financial Officer
and Corporate Secretary

Calgary, Canada

March 13, 2006

Auditors' Report

To the Shareholders of ProspEx Resources Ltd.

We have audited the consolidated balance sheets of ProspEx Resources Ltd. as at December 31, 2005 and 2004 and the consolidated statements of earnings and retained earnings and cash flow for the year ended December 31, 2005 and the three months ended December 31, 2004. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the company as at December 31, 2005 and 2004 and the results of its operations and its cash flow for the year ended December 31, 2005 and the three months ended December 31, 2004 in accordance with Canadian generally accepted accounting principles.

KPMG LLP

Chartered Accountants

Calgary, Canada

March 13, 2006

Consolidated Balance Sheet

(\$000s)

As At December 31,

2005

2004

Assets

Current assets

Cash	\$	–	\$	20,219
Accounts receivable		12,615		3,513
Prepaid expenses		619		2

13,234 23,734

Property, plant and equipment, net (note 3) 101,695 48,705

Future income tax asset (note 4) 6,041 4,929

\$ 120,970 77,368

Liabilities

Current liabilities

Accounts payable and accrued liabilities	\$	30,150	\$	11,842
Unrealized financial instrument loss		51		–

30,201 11,842

Long term debt (note 5) 1,053 –

Asset retirement obligation (note 6) 5,762 3,584

Total liabilities 37,016 15,426

Shareholders' Equity

Share capital (note 7) 66,136 60,081

Contributed surplus 3,882 756

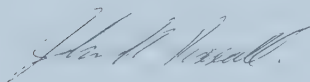
Retained earnings 13,936 1,105

83,954 61,942

\$ 120,970 \$ 77,368

See accompanying notes to consolidated financial statements.

On Behalf of the Board of Directors:



John W. Rossall

Director



Kyle D. Kitagawa

Director

Consolidated Statement of Earnings and Retained Earnings

(\$000s, except per share amounts)	For the Year Ended Dec. 31, 2005	For the Three Months Ended Dec. 31, 2004
Revenue		
Oil and gas	\$ 35,472	\$ 7,302
Unrealized financial instrument loss	(51)	
Royalties	(5,620)	(1,376)
	29,801	5,926
Expenses		
Operating	4,102	1,070
Depletion, depreciation and accretion	10,124	1,626
General and administrative	1,803	495
Interest and bank charges	(64)	6
Stock-based compensation	1,947	756
	17,912	3,953
Earnings before taxes	11,889	1,973
Taxes (note 4)		
Capital	61	17
Future income taxes (recovery)	(1,003)	851
	(942)	868
Net earnings for the period	12,831	1,105
Retained earnings, beginning of period	1,105	-
Retained earnings, end of year	\$ 13,936	\$ 1,105
Net earnings per share		
Basic	\$ 0.27	\$ 0.03
Diluted	\$ 0.26	\$ 0.02

See accompanying notes to consolidated financial statements.

Consolidated Statements of Cash Flow

(\$000s)	For the Year Ended Dec. 31, 2005	For the Three Months Ended Dec. 31, 2004
Operations		
Net earnings for the period	\$ 12,831	\$ 1,105
Items not involving cash		
Depletion, depreciation and accretion	10,124	1,626
Stock-based compensation	1,947	756
Future income taxes (recovery)	(1,003)	851
Unrealized financial instrument loss	51	–
Asset retirement expenditures	(599)	–
	23,351	4,338
Changes in non-cash working capital	2,233	3,864
	25,584	8,202
Financing		
Issuance of shares	5,946	29,605
Increase (decrease) in long-term debt	1,053	(10,654)
	6,999	18,951
Investments		
Exploration and development expenditures	(59,063)	(11,041)
Other capital assets	(94)	(356)
	(59,157)	(11,397)
Changes in non-cash working capital	6,355	4,463
	(52,802)	(6,934)
Change in cash	(20,219)	20,219
Cash, beginning of period	20,219	–
Cash, end of year	\$ –	\$ 20,219

See accompanying notes to consolidated financial statements.

Notes to Consolidated Financial Statements

For the year ended December 31, 2005, and for the three months ended December 31, 2004.

1. Significant Accounting Policies

ProspEx Resources Ltd. ("ProspEx" or the "Company") was incorporated on August 13, 2004 and commenced operations on October 1, 2004 when certain assets of Esprit Exploration Ltd. ("Esprit") were transferred to ProspEx under a Plan of Arrangement (the "Plan of Arrangement"). ProspEx is engaged in the acquisition, exploration, development and production of oil and natural gas in Canada.

These financial statements have been prepared in accordance with Canadian generally accepted accounting principles. The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reported period. Actual results may differ from these estimates.

(a) Consolidation

The consolidated financial statements include the accounts of the Company and its subsidiary. A substantial portion of the Company's activities are conducted jointly with others and the consolidated financial statements reflect only the Company's proportionate interest in such activities.

(b) Property, Plant and Equipment

The Company follows the full cost method of accounting for exploration and development expenditures whereby all costs relating to the acquisition of, exploration for and development of oil and gas reserves, including asset retirement costs, are capitalized. Such costs include lease acquisition, geological and geophysical, lease rentals on undeveloped properties, drilling both productive and non-productive wells, production equipment and overhead charges directly related to acquisition, exploration and development activities. Proceeds received from disposals of properties and equipment are credited against capitalized costs unless the disposal would alter the rate of depletion and depreciation by more than 20%, in which case a gain or loss on disposal is recorded.

Capitalized costs and estimated costs of future development of proved undeveloped reserves are depleted and depreciated by the unit of production method based on estimated gross proved reserves before royalties as determined by independent engineers. The costs of undeveloped properties are excluded from costs subject to depletion until it is determined whether or not proved reserves are attributable to the properties or impairment has occurred. Oil and gas reserves are converted to equivalent units using their relative energy content.

Oil and gas assets are evaluated in each reporting period to determine that the costs are recoverable and do not exceed the fair value of the properties. The costs are assessed to be recoverable if the sum of the undiscounted cash flows expected from the production of proved reserves and the lower of cost and market of unproved properties exceed the carrying value of the oil and gas assets. If the carrying value of the oil and gas assets is not assessed to be recoverable, an impairment loss is recognized to the extent that the carrying value exceeds the sum of the discounted cash flows expected from the production of proved and probable reserves and the lower of cost and market of unproved properties. The cash flows are estimated using future product prices and costs and are discounted using the risk-free rate.

Amortization of capital assets not related to oil and gas assets is provided using the declining balance method at a rate from 20 to 50% per annum. Leasehold improvements are amortized using the straight-line method over the terms of the respective leases.

(c) Asset Retirement Obligation

The Company records the fair value of legal obligations associated with the retirement of long-lived tangible assets, such as producing well sites, in the period in which they are incurred and a corresponding increase in the carrying amount of the related long-lived asset. The liability accretes until the Company expects to settle the retirement obligation. The asset retirement costs are depleted using the unit of production method. Actual costs to retire tangible assets are deducted from the liability as incurred.

(d) Income Taxes

The Company follows the asset and liability method of accounting for future income taxes. Under this method, future income tax assets and liabilities are determined based on differences between the amounts reported in the financial statements and the tax basis of the assets and liabilities, and are measured using the currently enacted, or substantively enacted, tax rates and laws expected to apply when these differences reverse.

(e) Stock-based Compensation

Stock options and special performance units granted have been accounted for based on the fair value method. The fair value is measured at the grant date and charged to earnings or capital assets over the vesting period with a corresponding increase in contributed surplus. For awards that vest on a graded basis, compensation cost is recognized on a pro-rata basis over the vesting period. Consideration paid to the Company on exercise of all options is credited to share capital.

(f) Financial Instruments

The Company uses derivative financial instruments to manage its exposure to volatility in commodity prices. These financial instruments are entered into solely for hedging purposes and are not used for trading or other speculative purposes.

Derivative instruments that qualify as hedges, and have been designated as hedges, are not recognized in the financial statement on inception. Gains or losses on commodity price financial instruments designated as hedges are reflected as adjustments to the related revenue when the gain or loss is realized.

Commodity price financial instruments that do not qualify as hedges, or have not been designated as such, are recorded at fair value on inception. Realized gains or losses on these financial instruments are reflected as adjustments to the related revenue when the gain or loss is realized; unrealized gains and losses on these instruments are recognized as adjustments to the related revenue at the end of each reporting period. The estimated fair value of these instruments is based on quoted market prices, or if quotes are not available, third party market indications and forecasts are used.

(g) Earnings Per Share

The Company uses the treasury stock method to determine the dilutive effect of outstanding stock options, special performance units and warrants. Basic and diluted earnings per share are calculated using the weighted average number of common shares outstanding during the period. Diluted per share amounts reflect the potential dilution that could occur if securities or other contracts to issue common shares were exercised or converted to common shares. Anti-dilutive options and warrants are excluded from the calculation.

(h) Revenue Recognition

Revenue from the sale of crude oil, natural gas and natural gas liquids is recorded when title passes.

2. Plan Of Arrangement/Related Party Transaction

Effective October 1, 2004, pursuant to the Plan of Arrangement, Esprit transferred certain property, plant and equipment to ProspEx. The Plan of Arrangement resulted in, amongst other matters, Esprit shareholders receiving 0.20 of a voting common share of ProspEx for every common share in Esprit. 32,810,106 common shares were issued as a result of the Plan of Arrangement. At the time of the transaction, Esprit and ProspEx were related parties resulting in the transfer of assets at Esprit's carrying value. The net assets transferred are comprised of as follows:

(\$000s)	
Property, plant and equipment	\$ 38,843
Future tax asset	5,432
Long term debt	(10,654)
Asset retirement obligation	(3,492)
Net assets transferred	\$ 30,129

In conjunction with the Plan of Arrangement, ProspEx and Esprit entered into an administrative and technical service agreement pursuant to which Esprit provided certain administrative and technical services to ProspEx. This agreement expired March 31, 2005. However; the information technology support portion of the agreement was extended until March 31, 2006. Total charges for the agreement in 2005 were \$123,524 (2004 - \$94,074).

ProspEx also entered into a marketing arrangement with Esprit, under which ProspEx sold its production to Esprit for market prices less a marketing charge of \$0.02 per Gigajoule ("GJ") until June 30, 2005. Total charges for the marketing agreement for 2005 were \$41,009 (2004 - \$22,012).

Also pursuant to the Plan of Arrangement ProspEx entered into an agreement to sublease office space from Esprit. During the year ProspEx received an incentive of \$401,586 plus disbursement costs to surrender the initial sublease and enter into a new agreement to sublease office space until January 31, 2009 at a different location. The incentive is being drawn down over the term of the lease.

3. Property, Plant and Equipment

\$000s)	2005	2004
Oil and gas properties	\$ 112,669	\$ 49,932
Other	449	356
	113,118	50,288
Less accumulated depletion, depreciation and amortization	(11,423)	(1,583)
Total property, plant and equipment	\$ 101,695	\$ 48,705

At December 31, 2005, oil and gas properties included \$19.5 million (2004 - \$17.9 million) of unproved properties which have been excluded from the depletion calculation. Future development costs related to proved undeveloped reserves of \$11.4 million (2004 - \$1.9 million) are included in the depletion calculation.

During 2005, the Company capitalized \$2.6 million (2004 - \$0.5 million) of overhead and stock-based compensation costs directly related to acquisition, exploration and development activities.

At December 31, 2005, the Company applied a ceiling test to its oil and gas assets using expected future market prices of:

	Gas (\$ per thousand cubic feet) ¹	Natural gas liquids (\$ per barrel) ¹	Oil (\$ per barrel) ²
2006	10.72	63.08	73.15
2007	10.50	63.52	73.67
2008	10.00	61.60	71.44
2009	8.85	59.47	68.97
2010	8.11	58.31	67.62
2011	6.54	43.26	53.25
2012	6.54	43.26	52.25
2013	7.05	44.03	53.25
2014	7.20	44.89	54.25
2015	7.40	45.86	55.50
2016	7.55	46.83	56.50
2017+	+2%	+2%	+2%

¹ Weighted average plantgate price.

² Weighted average wellhead price.

4. Future Income Taxes

The provision for future income taxes differs from the amount computed by applying the combined expected Canadian Federal and Provincial tax rates to earnings before income taxes. The reasons for these differences are as follows:

(\$000s)	For the Year Ended Dec. 31, 2005	For the Three Months Ended Dec. 31, 2004
Earnings before taxes	\$ 11,889	\$ 1,973
Rate	37.62%	38.62%
Computed expected provision for future income taxes	4,473	762
Increase (decrease) in taxes resulting from:		
Valuation allowance changes	(5,131)	–
Non-deductible crown payments	374	302
Resource allowance	(1,415)	(314)
Stock-based compensation	1,176	292
Effect of change in tax rate	(248)	(246)
Other	(232)	55
	(1,003)	851
Capital taxes	61	17
Income tax expense (recovery)	\$ (942)	\$ 868

The components of the future income tax asset at December 31, 2005 are as follows:

(\$000s)	2005	2004
Tax assets:		
Property, plant and equipment	\$ 5,097	\$ 9,077
Asset retirement obligation	1,082	1,205
Share issue costs	362	278
	6,541	10,560
Valuation allowance	(500)	(5,631)
Future income tax asset	\$ 6,041	\$ 4,929

At December 31, 2005, the Company had estimated tax deductions available to reduce future taxable income of \$116.0 million (2004 – \$78.0 million). ProspEx has committed to incur \$6.1 million in qualifying expenditures related to the flow-through share arrangement by December 31, 2006.

5. Long-term Debt

At December 31, 2005 the Company had a \$40.0 million credit facility with a Canadian chartered bank. The facility is available by way of Canadian and US dollar prime rate based loans, LIBOR advances, bankers' acceptances and letters of credit. The credit facility is fully revolving until June 30, 2006 and may be extended at the mutual agreement of ProspEx and its lender for an additional year. If the credit facility is not extended, a balloon payment is required on July 1, 2007. This facility is secured by a \$200 million demand debenture and a first floating charge on all petroleum and natural gas assets of ProspEx.

6. Asset Retirement Obligation

The Company has estimated the net present value of its total asset retirement obligation at December 31, 2005 to be \$5.8 million (2004 - \$3.6 million) based on a total future liability of \$13.4 million. The total future liability was estimated based on the Company's net ownership interest in all wells and facilities, estimated costs to reclaim and abandon the wells and facilities and the estimated timing of when the costs will be incurred. These payments are expected to be made over the next 35 years with the majority of costs incurred between 2020 and 2028. A 7% interest rate and 2% inflation rate were used to calculate the asset retirement obligation.

(\$000s)	2005	2004
Balance, beginning of period	\$ 3,584	\$ -
Liabilities incurred	2,493	49
Assumed liability pursuant to the plan of arrangement	-	3,492
Accretion expense	284	43
Liabilities settled	(599)	-
Balance, end of year	\$ 5,762	\$ 3,584

7. Share Capital

(a) Authorized

An unlimited number of common shares and non voting common shares and an unlimited number of preferred shares are authorized for issuance.

(b) Common Shares & Common Share Performance Warrants Issued

	2005		2004	
	Number of Shares/Warrants (000s)	Amount (\$000s)	Number of Shares/Warrants (000s)	Amount (\$000s)
Common shares				
Balance at the beginning of the period	47,111	\$ 58,116	32,810	\$ 30,129
Issued for cash on exercise of transferred options	-	-	972	1,654
Issued for cash as private placement – October 1, 2004	-	-	6,429	9,000
Less: Value ascribed to common share performance warrants	-	-	-	(1,965)
Issued for cash as private placement – December 3, 2004	-	-	6,900	20,010
Flow-through shares issued for cash	1,400	6,090	-	-
Shares issued under special performance unit plan	277	3	-	-
Shares issued for warrants	151	322	-	-
Common shares repurchased	(7)	(8)	-	-
Issue costs, net of future tax reduction	-	(240)	-	(712)
Balance at the end of the year	48,932	\$ 64,283	47,111	\$ 58,116
Common share performance warrants				
Balance at the beginning of the period	3,214	\$ 1,965	3,214	\$ 1,965
Exercised	(151)	(93)	-	-
Cancelled	(31)	(19)	-	-
Balance at the end of the year	3,032	\$ 1,853	3,214	\$ 1,965
Share Capital at the end of the year		\$ 66,136		\$ 60,081

On December 21, 2005 ProspEx issued 1.4 million common shares on a flow through basis at a price of \$4.35 per share for total gross proceeds of \$6.1 million. ProspEx has committed to incur \$6.1 million in qualifying expenditures related to the flow-through share financing by December 31, 2006.

On December 3, 2004 ProspEx completed a private placement of 6.9 million common shares for gross proceeds of \$20.0 million. These funds were used to fund the 2005 capital program

On October 1, 2004 ProspEx completed a private placement of 6.4 million common shares and 3.2 million warrants for gross proceeds of \$9.0 million. Each warrant entitles the holder to acquire a common share at a price of \$1.40. The warrants expire on October 1, 2009. The fair value of the warrants was estimated to be \$1.9 million, using the Black-Scholes option pricing model with the following weighted average assumptions:

Risk free interest rate:	4%
Expected life:	5 years
Expected volatility:	50%
Expected dividend yield:	Nil

The estimated fair value of the warrants was recognized as a reduction of the common share capital with a corresponding increase to common share performance warrants.

(c) Contributed Surplus

(\$000s)	2005	2004
Balance, beginning of period	\$ 756	\$ –
Stock-based compensation	3,126	756
Balance, end of year	\$ 3,882	\$ 756

(d) Stock Options and Special Performance Units

ProspEx has a stock option plan for directors, officers and employees which provides for the granting of options to acquire common shares. Under the terms of the plan, options normally vest equally over a three year period, and expire five years after the date of grant. At December 31, 2005, options to acquire 4.7 million common shares were authorized for issuance under the stock option plan. Changes in outstanding options during the period ended December 31, 2005 and December 31, 2004 are summarized below:

	2005		2004	
	Options (000s)	Weighted Average Exercise Price	Options (000s)	Weighted Average Exercise Price
Outstanding at beginning of period	1,862	\$ 3.23	–	\$ –
Options transferred pursuant to plan of arrangement	–	–	972	1.70
Granted	452	3.45	1,862	3.23
Exercised	–	–	(972)	1.70
Outstanding, end of year	2,314	\$ 3.27	1,862	\$ 3.23

ProspEx has a special performance unit ("SPU") plan for directors, officers and employees. All of the authorized 1,307,995 SPU's were granted on October 1, 2004. The number of common shares issuable upon exercise of vested SPU's is determined by taking the vested SPU's multiplied by the closing trading price of the common shares less \$1.40 divided by the closing price. If the closing trading price less \$1.40 is less than zero the Corporation will redeem the SPU's at a redemption price of \$0.01. Over three years following the grant, one third of the SPU's vest on the anniversary of the issuance pending minimum share performance requirements. Once performance units have vested they may be exercised in whole or in part, at any time within 30 days of the vesting date. Changes in SPU's during the period ended December 31, 2005 and December 31, 2004 are as follows:

[000s]	2005	2004
Outstanding at beginning of period	1,308	1,308
Exercised	(436)	—
Outstanding, end of year	872	1,308

The fair value of each stock option and special performance unit granted is estimated on the date of the grant using the Black-Scholes option pricing model with the following weighted average assumptions for grants as follows:

	2005	2004
Risk free interest rate	4%	4%
Expected life	5 years	5 years
Expected volatility	45%	50%
Expected dividend yield	Nil	Nil

The estimated fair value of stock options and special performance units in 2005 was \$0.6 million (2004 – \$5.4 million). This estimated fair value is being amortized to earnings and capitalized to plant, property and equipment over the vesting period. \$1.9 million (2004 - \$0.7 million) of stock and unit-based compensation was recorded against income in 2005 and \$1.2 million (2004 – \$nil) was capitalized.

(e) Per Share Amounts

Basic per share amounts are calculated using the weighted average number of common shares outstanding during the period. Diluted per share amounts are calculated based on the treasury stock method, which assumes that any proceeds obtained on exercise of options would be used to purchase common shares at the average price during the period. The weighted average number of shares outstanding is then adjusted by this amount. In computing diluted net earnings per share for the year ended December 31, 2005, 2,736,927 (2004 – 2,681,015) common shares were added to the weighted average number of common shares outstanding of 47,239,317 (2004 – 42,184,255). A total of 201,500 (2004 – 250,000) options were excluded from the diluted calculations as they were not dilutive.

8. Financial Instruments And Risk Management

The Company uses derivative financial instruments to manage its exposure to volatility in commodity prices. These financial instruments are entered into solely for hedging purposes and are not used for trading or other speculative purposes.

At December 31, 2005, ProspEx had a costless collar for 2,500 GJ per day with a floor price of \$7.00 per GJ and a ceiling of \$11.66 per GJ at AECO. This collar will expire on March 31, 2006. The Company elected to account for this financial contract using the mark-to-market method. At December 31, 2005 the estimated fair market value of the financial contract was \$0.1 million resulting in an unrealized financial instrument loss recorded against income.

Subsequent to year end ProspEx entered into a collar for 6,000 GJ per day from April 1, 2006 to October 31, 2006, with a floor price of \$6.75 per GJ and a ceiling of \$9.00 per GJ at AECO; purchased an AECO call option for 6,000 GJ per day from April 1, 2006 to October 31, 2006 at \$10.00 per GJ; and entered into a NYMEX to AECO basis contract for 2,637 GJ per day from April 1, 2006 to June 30, 2006 at NYMEX less US\$1.18 per GJ.

The majority of the Company's accounts receivable are with customers and joint-venture partners in the oil and gas industry and are subject to normal industry credit risks. Customers and joint-venture partners are subject to an internal credit review to minimize the risk of non-payment.

The Company is exposed to a floating rate of interest on its long-term debt. The Company is also exposed to foreign currency fluctuations as oil prices received are referenced to US dollar denominated prices and natural gas and natural gas liquids prices are influenced by US dollar denominated markets. The Company has no financial contracts in place at December 31, 2005 to manage the foreign currency and interest rate exposure.

The fair values of the financial instruments, including accounts receivable, accounts payable, accrued liabilities and bank loans approximate their carrying values.

9. Additional Disclosures

Net cash interest received during the year was \$145,737 (2004 – interest paid \$6,425). Cash taxes paid during the year was \$29,793 (2004 – \$ nil).

10. Commitments

The Company has committed to certain payments over the next four years as follows:

Payments due (\$000s)	2006	2007	2008	2009	Thereafter
Building Lease	\$ 350	\$ 353	\$ 353	\$ 29	\$ –
Software licenses	108	–	–	–	–
Other	6	6	4	–	–
Total	\$ 464	\$ 359	\$ 357	\$ 29	\$ –

ProspEx has also committed to incur \$6.1 million in qualifying expenditures related to the flow-through share arrangement by December 31, 2006.

Corporate Information

Officers

R. Scott Godzman | Vice President, Land

Jean-Paul H. Lachance | Vice President, Engineering

Peter J. Luxton | Vice President, Exploration

John W. Rossall | President and Chief Executive Officer

George D. K. Yee | Vice President, Finance, Chief Financial Officer and Corporate Secretary

Directors

Brian E. Hiebert⁽¹⁾, ⁽²⁾ | Chairman of the Corporate Governance and Compensation Committee
President, B&G Energy | Calgary, Alberta

Kyle D. Kitagawa⁽¹⁾, ⁽²⁾ | Chairman of the Audit Committee
Managing Director, North River Capital Corp. | Calgary, Alberta

Ian MacGregor⁽¹⁾, ⁽²⁾
President, North West Capital | Calgary, Alberta

John W. Rossall | President and Chief Executive Officer
ProspEx Resources Ltd. | Calgary, Alberta

Stephen J. Savidant | Chairman of the Board of Directors
President and Chief Executive Officer, Esprit Energy Trust | Calgary, Alberta

Auditors

KPMG LLP
Calgary, Alberta

Registrar and Transfer Agent

Olympia Trust Company
Calgary, Alberta

Solicitor

Bennett Jones LLP
Calgary, Alberta

Stock Exchange Listing

The Toronto Stock Exchange
Trading Symbol: PSX

Bankers

Canadian Imperial Bank of Commerce

Website

www.psx.ca

Independent Reserves Evaluator

GLJ Petroleum Consultants Ltd.
Calgary, Alberta

⁽¹⁾ Member of the Corporate Governance and Compensation Committee

⁽²⁾ Member of the Audit Committee



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